Interview by Vinson & Elkins
with Bruce Herring

at footnote(s):

256, 261

FINAL

M E M O R A N D U M

July 2, 2004

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TO: Paul S. Maco
Rick C. Sauer

FROM: Maria E. Bickerton

RE: *City of San Diego*; Interview of Bruce Herring

This memorandum summarizes the interview of Bruce Herring, Deputy City Manager and former member of the CERS board (the "Board"). The interview was conducted by Rick Sauer and Maria Bickerton. The interview took place on the morning of June 10, 2004. Also in attendance was Edward Patrick Swan of Luce Forward, serving as legal counsel to Mr. Herring. Mr. Herring had previously been interviewed by Rick Sauer and Ben Lippard. A separate memorandum was prepared by Mr. Lippard summarizing that earlier interview.

This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of thoughts and mental impressions regarding the discussion. Significantly, it is organized to summarize issues thematically and, although it does chronologically follow the interview to an extent, it does not necessarily reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange, and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case and does not provide context or explanation of every factual reference. It also does not attempt to completely describe or explain the retirement system issues discussed. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

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I. Manager's I

A. Intention to Return to the EAN Rate

Mr. Sauer wanted to start off by getting a little more detail on Manager's I. Mr. Herring confirmed that he joined the CERS board in 1996. Mr. Sauer asked whether Manager's I was on the agenda around then. Mr. Herring said that it was. He explained that the City had already gone from EAN to PUC. Mr. Sauer asked whether anybody indicated why this was done. Mr. Herring did not remember. He believed it was based on the recommendation of John King, who was at one point with Buck Consulting and was the actuary who preceded Rick Roeder.

Mr. Sauer asked what the effect was of going from EAN to PUC. Mr. Herring said that he did not know for a fact but believed it resulted in a reduction in the City's contribution rate. Mr. Herring said he thinks PUC is more sensitive to certain variations such as age changes than EAN. Mr. Sauer asked whether it came to Mr. Herring's attention that Board members wanted to return to EAN. Mr. Herring said this came up in the discussion of Manager's I. The City was supposed to make the switch when the EAN rate and the PUC rate met. Mr. Herring noted that there was no agreement for Manager's I, but the proposal for Manager's I has this crossover to EAN mentioned in it.

Mr. Sauer showed Mr. Herring the Manager's I proposal. Mr. Herring said that he was not certain if it was the final one. Assuming it was the final one, he confirmed it was the document to which he was referring. Mr. Herring explained that he believes Cathy Lexin drafted it. Mr. Sauer asked whether, at that point, Mr. Herring was a Deputy City Manager. Mr. Herring confirmed that he was. Mr. Sauer asked if Mr. Herring was involved in drafting the proposal. Mr. Herring explained that he was not, but he was sure that he reviewed it because Ms. Lexin worked directly for him at the time. Mr. Sauer referred to page 6 of the Manager's I proposal. He noted a statement in the proposal regarding an intention to switch to EAN at such time as the EAN rate and the PUC rate are equal. Mr. Herring affirmed that this was the statement to which he was referring.

B. Action By City on Manager's I

Mr. Sauer asked whether any formal action was taken on Manager's I by the City. Mr. Herring said he believes there was an ordinance to make changes to the Municipal Code for Manager's I. Mr. Sauer asked whether anyone ever claimed that Manager's I was not binding on the City. Mr. Herring said he did not remember the point being raised. However, Mr. Herring noted that the proposal was binding on the City to the extent it was incorporated into the Municipal Code.

C. Effect of the Trigger

Mr. Sauer wanted to know Mr. Herring's interpretation of what would happen if the 82.3% trigger in Manager's I were hit. Mr. Herring affirmed that his interpretation was that, if the floor were breached, the City would begin paying the full PUC rate. Specifically, Mr. Herring thought it required the City to pay the rate determined by the actuary at an 82.3% level of funding. To Mr. Herring, this did not mean that the City would have to pay a lump sum in order to restore the funded ratio to 82.3%. Rather the rate would be increased taking into account the actuarial determination to bring the funded ratio back to 82.3%. Mr. Sauer asked whether there was a dispute over the time frame to restore the funded ratio back to the floor. Mr. Herring responded that the time frame was that the City would have to pay the full actuarial rate the next time the valuation was done. The difference between the floor and the funded ratio would be built into the actuarial rate.

Mr. Sauer proposed a hypothetical example where the funded ratio fell to 80%. The floor would have been breached, and the actuary would calculate the rate as a percentage of payroll that would be necessary to bring the fund back to 82.3%. Mr. Herring agreed with Mr. Sauer's hypothetical. Mr. Sauer pointed out that this was different than the City paying the full PUC rate. That is, the number the actuary would generate for the PUC rate is different than the number the actuary would generate to bring the City back to 82.3%. Mr. Herring agreed that Manager's I required restoration to 82.3%.

D. City's Need for Rate Relief

Mr. Sauer noted that, based on his review of Board minutes, it appeared that the discussion about the City's wanting rate relief began sometime in 1995. Mr. Herring affirmed this. Mr. Sauer wanted to know why the City wanted rate relief. Mr. Herring explained that the economy was bad, the budget was artificially reduced due to state actions (property tax had been shifted from cities and counties to schools to relieve the State's obligation to pay the schools in 1993 or 1994), and the contribution rates had increased more rapidly than expected. Mr. Herring was not sure why the contribution rates had increased, but the increase was unforeseen.

Mr. Sauer asked if Mr. Herring remembered whether, at the time of Manager's I, the actuary had indicated to the Board that there would be significant changes in the actuarial assumptions that would drive the rates up. Mr. Herring explained that the assumption changes the Board knew about were included in the Manager's I package. Manager's I contained a chart comparing the Manager's I rates with the expected actuarial rates. The actuarial rates in the chart reflected all the actuarial assumptions as of that date. The chart was the actuary's best estimate at the time.

E. Effect on Manager's I Rates If New Benefits Granted

Mr. Sauer asked whether there was any discussion about what would happen if there were new benefits granted by the City. Mr. Herring did not remember it being raised as an issue, and Manager's I did not address it. Mr. Sauer asked whether Mr. Herring thought it should have been addressed in the proposal. Mr. Herring responded that the City had just granted additional benefits, so the City was not really thinking about future benefit increases.

F. Funding for the Manager's I Shortfall

Mr. Sauer turned to the last page of Manager's I under the heading "Contribution Shortfall Liability." Mr. Sauer noted that this section of Manager's I stated that the surplus undistributed earnings and the balance in the Earnings Stabilization Reserve totaled over $135 million. Mr. Sauer asked Mr. Herring whether it was intended that the shortfall arising from the Manager's I contribution schedule would somehow be paid from these sources. Mr. Herring said that he did not remember. Mr. Herring had no recollection of the Earnings Stabilization Reserve. Mr. Herring also did not recall the idea that excess earnings from 1995 or 1996 would be applied toward the shortfall. However, Mr. Herring said it would not surprise him if this was the intent. Mr. Herring explained that the general theory would be that, if the City has provided for a benefit increase of $50 million and there is a $50 million surplus, the benefit increase would be paid off with the surplus and not amortized. Mr. Herring noted that Ed Ryan, Terri Webster, and Larry Grissom would be knowledgeable about these matters.

Mr. Sauer asked whether Mr. Herring was familiar with the NPO concept. Mr. Herring said he believes the NPO reflected the difference between the amount paid by the City each year and the actuarial contribution rate for each year. Mr. Herring said the NPO was reflected in the actuarial report, but he did not know whether it was reflected as a liability on the financial statements.

Mr. Sauer referred to the pension disclosure in the 2003 Official Statement and asked whether Mr. Herring had ever seen it before. Mr. Herring said he had not seen it. He explained that he never reviewed the bond disclosures. Mr. Sauer commented that the disclosure indicated that the Manager's I shortfall was being funded in reserve. Mr. Herring did not know what that reserve would be. This was the first time he had ever heard it mentioned.

G. *Reactions to Manager's I*

(1) Larry Grissom's Reaction

Mr. Sauer asked whether Mr. Herring recalled Larry Grissom's views on Manager's I. Mr. Herring said he did not specifically recall. He did not remember whether Larry supported it, opposed it, or was agnostic.

(2) Rick Roeder's Reaction

Mr. Sauer inquired whether Rick Roeder was the actuary at the time of Manager's I. Mr. Herring said he believed he was. Mr. Sauer asked whether Mr. Roeder had any criticisms of the proposal. Mr. Herring said that Mr. Roeder was not critical of Manager's I and that he may have brought the corridor concept to the table with Larry. Mr. Sauer asked how Mr. Roeder explained the corridor funding concept. Mr. Herring responded that Mr. Roeder said it was alright to pay less than the actuarial rate and ramp up as long as the rate remained within a certain range of the actuarial rate. Mr. Sauer asked whether Mr. Roeder said the method was accepted by GASB. Mr. Herring said he did not remember.

(3) Board Members' Reactions

Mr. Herring confirmed that Connie Jameson was on the Board at the time of Manager's I. He did not remember if she was against it. He only remembered Jack Katz being opposed to Manager's I because Jack felt that the retirees should get more out of it. Mr. Sauer asked whether Mr. Herring recalled Paul Barnett's position on Manager's I. Mr. Herring said he thinks Paul voted against Manager's I, but he did not remember directly.

Mr. Sauer presented Mr. Herring with an e-mail from Cathy Lexin dated April 25, 1996, and asked if it looked familiar. Mr. Herring did not remember it but confirmed that it was addressed to him. Mr. Sauer commented that the e-mail mentioned that outside Board members were feeling used and were frustrated with the Manager's office. Mr. Herring did not remember what Cathy meant by this. Mr. Sauer noted a comment in the e-mail about Keith and asked Mr. Herring who Keith was. Mr. Herring explained that Cathy was probably referring to the chairman of the Board, Keith Enerson. Mr. Herring said the e-mail was probably about Manager's I and the City's desire for rate relief. However, Mr. Herring did not remember any push back from the outside members or frustration with the Manager's office. At this point, Edward Swan noted that the only documents Mr. Herring had reviewed were the selected group of documents that Mr. Sauer provided prior to the interview. He commented that Mr. Herring's memory might be refreshed with further document review.

(4) Fiduciary Opinions

Next Mr. Sauer brought to Mr. Herring's attention a 1996 letter from Jones Day. Mr. Herring did not remember this letter nor did he remember asking Jones Day for a fiduciary counsel opinion on Manager's I. Mr. Herring did, however, remember that the Board obtained a fiduciary opinion at the time of Manager's I. Mr. Herring noted that the substance of the opinion was that it was fine for the Board to approve Manager's I.

H. Manager's I Benefit Increases

Mr. Sauer asked whether the benefits provided by Manager's I were contingent on the Board's approval of Manager's I. Mr. Herring said the benefit increases were not as clearly contingent on the Board's approval as they were with Manager's II. Mr. Sauer asked whether the benefits would have taken effect if the Board had rejected Manager's I. Mr. Herring said they may have taken effect, but there was no way to know. It would have involved decision making by labor, management, and elected officials. Mr. Sauer queried whether any Board member complained about being involved in labor negotiations. Mr. Herring said he did not remember such complaints with Manager's I, only with Manager's II.

II. Corbett

Mr. Sauer referred to an e-mail to Mr. Herring from Terri Webster regarding *Corbett*. Mr. Herring confirmed that he was actively involved in negotiating the *Corbett* settlement. He said that David Hopkins as outside counsel was also involved, along with Larry Grissom and Teresa McAteer from the City Attorney's office. Mr. Herring explained that the lawsuit was based on *Ventura County*. The plaintiffs alleged that certain compensation not considered in determining a participant's highest one-year of compensation should have been included. In lieu of including that compensation, the City agreed to a benefit increase for existing employees, a one-time increase of about 7% for the retirees, and a variation for the DROP group. These benefit increases amounted to less than what the City would have been required to pay if the plaintiffs had won the lawsuit. Mr. Sauer asked whether the meet and confer benefits were part of the *Corbett* settlement. Mr. Herring said he believed they were part of the settlement. He noted that *Corbett* involved the four unions and the retirees against the City. The negotiations were with all of them. Mr. Herring also commented that the labor negotiations were occurring at the same time as the *Corbett* negotiations. In Mr. Herring's mind, the meet and confer benefits were part of the settlement.

Mr. Herring explained that the *Corbett* settlement was based on the benefits being contingent. That is, the benefits would be paid only if there were enough surplus earnings in a year. If not, the liability would be carried forward until there were surplus earnings. Mr. Sauer inquired about the non-contingent *Corbett* benefits. Mr. Herring said he was not sure which part of the settlement was non-contingent. He thought it was the benefit increases given to the regular active employees, but he said the City Attorney's office should have the *Corbett* settlement on file. Mr. Sauer asked why some of the *Corbett* benefits were made contingent. Mr. Herring explained that it was structured to be contingent so that it would not be a vested benefit.

Mr. Sauer asked whether Mr. Herring had ever heard the argument that the *Corbett* benefits were not contingent. Mr. Herring said he had heard the argument before, particularly from Dick Vortmann. Mr. Herring thought the topic had come up at Board meetings, and he was sure Diann Shipione had said it. Mr. Sauer asked whether anyone had argued that the *Corbett* benefits should be included in the actuarial valuation, and Mr. Herring said Dick Vortmann, Diann Shipione, and the Pension Reform Committee argued that it should be included. Mr. Herring said that the City would not include the benefits in the actuarial valuation, at least not in 2005 because they reached a settlement in *Gleason* to do it a different way.

Mr. Sauer referred to an e-mail from Terri Webster dated April 6, 2000, regarding information being provided to the City Council on the *Corbett* settlement. Mr. Sauer read the following sentences from the e-mail: "We also recommend that you tell Council the facts regarding how the 90% funding contingency got met. Yes, we legally met it but it is misleading." Mr. Sauer asked Mr. Herring to explain why Terri said the statement was misleading. Mr. Herring explained that the Port handled funding differently than the way in which the City handled funding. This difference allowed the City and the Port together to have a 90% funded ratio, while the City itself technically had a funded ratio below 90%. Terri wanted an explanation of this in writing from Mr. Roeder, which resulted in a memorandum to the City Council.

III. Mr. Herring's Opinion of Rick Roeder

Mr. Sauer initiated a discussion about Mr. Herring's opinion of Mr. Roeder. Mr. Herring confirmed that he was not a fan of Mr. Roeder's. However, he clarified that he was not critical of Mr. Roeder's skills as an actuary. Rather, Mr. Herring was critical of Mr. Roeder's style and approach as an actuary in how he delivered his message.

IV. Reserves

Mr. Sauer asked whether Mr. Herring had an understanding of the CERS reserves while he was on the Board. Mr. Herring said he was probably a C student on the reserves. He explained that some understood the reserves better than others. Specifically, Mr. Herring mentioned that Ron Saathoff probably understood the reserves best because he had the most continuity with the system. Mr. Herring also commented that, from the City side, Ed Ryan and Connie Jameson probably understood the reserves best.

V. Manager's II

A. Fiduciary's Reaction to Manager's II

Mr. Sauer began a discussion about Manager's II by referring to a CERS staff memorandum, dated June 13, 2002. Mr. Sauer noted that Mr. Herring was not on the Board at that time but asked if he was involved on behalf of the City. Mr. Herring said he made the second, third, and possibly fourth presentations to the Board regarding Manager's II. Mr. Sauer noted that, as of June 13, the Board had a draft letter from fiduciary counsel. Mr. Sauer asked whether Mr. Herring remembered seeing this letter at the time. Mr. Herring said he did not remember seeing the letter. He remembered a powerpoint presentation by the fiduciary advising the Board on the type of process required for the Board members to fulfill their fiduciary duties. The presentation that Mr. Herring remembered did not address the substance of the decision.

Mr. Sauer commented that, in his letter, Bob Blum expressed many reservations about Manager's II. For example, at the bottom of page 7, Mr. Blum noted that the ratio was the lowest it had been in 14 years and that CERS would have little if any surplus earnings. At the end, under the risk section, Mr. Blum stated that the Board could approve Manager's II, but they might get sued. Mr. Sauer asked whether Mr. Herring remembered Mr. Blum taking this position. Mr. Herring remembered that Mr. Blum voiced concerns about it in his public presentation. Also, Mr. Herring remembered that, toward the end of the process, he was asked to get on a conference call with Mr. Blum to address some issues. Mr. Herring commented that Mr. Blum's final letter concluded that it was alright for the Board to approve the agreement. Mr. Herring said they made changes to the agreement to make him feel more comfortable. In particular, Mr. Blum wanted the statement that appears in Manager's II that the City would make its best effort to return to the EAN rate.

Mr. Sauer noted that one of the criticisms of Diann Shipione with regard to Manager's II is that it does not require a return to the EAN rate when Manager's I did. Mr. Herring responded that he did not know if it was binding under Manager's I. That was a legal question. Mr. Sauer asked if there was some reason Manager's II was done as a contract while Manager's I was not. Mr. Herring said he did not know why Manager's II was done differently.

Mr. Herring confirmed that Mr. Blum had other concerns, but the return to EAN was the only one he remembered specifically. Mr. Sauer wanted to know if Mr. Herring remembered anything about a change with respect to the floor. Mr. Herring explained that the City wanted a

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lower floor but, in the end, they raised it back up. Mr. Herring did not remember Mr. Blum or Mr. Roeder putting much significance on the change in the floor.

B. Rick Roeder's Reaction to Manager's II

Mr. Sauer asked if Mr. Herring remembered Mr. Roeder's position on Manager's II. Mr. Herring said that Mr. Roeder was pretty opposed to Manager's II. Mr. Herring felt that Mr. Roeder was advising on policy rather than just acting as an actuary. Mr. Sauer then referred to a document entitled "Actuarial Information Regarding Manager's Proposal," which was dated June 12. Mr. Herring confirmed that this was part of Mr. Roeder's PowerPoint presentation to the Board on Manager's II. Mr. Herring also remembered Mr. Roeder's "Which Way Ya Goin'?" slide. Mr. Herring did not remember Mr. Roeder expressing concern about the Board being placed in the middle of labor negotiations, but he did remember complaints about this from the private Board members. Mr. Sauer referred to another document prepared by Mr. Roeder containing "Yes-No" questions and answers. Mr. Sauer asked Mr. Herring specifically about Mr. Roeder's observation in this document that, on an EAN basis, San Diego had one of the lowest funded ratios in the State of California. Mr. Herring did not remember this observation specifically.

Mr. Sauer asked Mr. Herring what his reaction was to Mr. Roeder's presentation. Mr. Herring said that everyone needed to discuss the issues and that it was good to have debate. Mr. Herring also said that he probably talked to Mr. Roeder about the presentation, but he did not remember what was said. Mr. Herring noted that he may have made a comment to the effect that Mr. Roeder should keep the cartoons out of his presentations. Mr. Herring remembered that Mr. Roeder had one slide with a cartoon of a skier. Mr. Herring said this was an example of his stylistic differences with Mr. Roeder. Mr. Sauer wanted to know if Mr. Herring thought there were any opinions expressed by Mr. Roeder that were incorrect or inappropriate. Mr. Herring could not remember. Mr. Herring said he had some concern that Mr. Roeder would derail the process, but he said he always worried about that when someone expressed a different point of view.

Mr. Sauer asked whether there were any efforts to get Mr. Roeder to support Manager's II after Mr. Roeder stated his initial position. Mr. Herring explained that the proposal was modified. The floor was adjusted, and the City agreed to pay the full cost of any additional benefits. Mr. Herring said that the modifications were really addressed to the Board's concerns. Mr. Sauer asked whether the board would have agreed to the proposal without the approval of the actuary and fiduciary counsel. Mr. Herring thought it was very unlikely that they would because of the fiduciary liability. They would not vote for it if they did not get approval from fiduciary counsel. Mr. Herring was not sure whether they would have approved it without the actuary's blessing.

Mr. Sauer commented that Mr. Roeder appeared to acquiesce to Manager's II in his letter of November 5, 2002. Mr. Sauer asked Mr. Herring whether he knew what changed Mr. Roeder's views from the June presentation to the Board to November. Mr. Herring said he did not know. He said it may have been the changes to the proposal. Mr. Herring did not think any pressure was put on Mr. Roeder to acquiesce.

C. *Board Member Concerns About Manager's II*

Mr. Sauer presented a memorandum from Mr. Herring to Larry Grissom dated July 3, 2002. Mr. Herring said that he remembered the memorandum. Mr. Sauer asked if Mr. Herring remembered why he drafted this memorandum. Mr. Herring said it was drafted by Cathy Lexin, and he signed it. It was prepared in response to issues raised at a Board meeting on Manager's II in between the first and second or the second and third presentations on Manager's II. Mr. Herring explained that the memorandum reflected changes made to the Manager's II proposal in response to the concerns of the Board members.

Mr. Sauer asked whether Mr. Herring remembered Dick Vortmann criticizing Manager's II. Mr. Herring said he did. He remembered that Dick was concerned about the retiree health liabilities and Corbett. Dick thought those two issues should be dealt with first. Mr. Sauer asked if Mr. Herring remembered the Blue Ribbon Committee ("BRC") report. Mr. Herring remembered it. He said he was not involved with its preparation and was not really aware of it when it was first issued. He was not sure he read the report. Mr. Sauer commented that Dick Vortmann was on the BRC and expressed views in the BRC report similar to the concerns he expressed with regard to Manager's II (i.e., concerns about the retiree health liabilities and Corbett). Mr. Sauer asked who was responsible for nominating Dick to the Board. Mr. Herring said it came from the Mayor's office, but he did not know who specifically nominated him.

Mr. Sauer referred to a document containing Mr. Herring's responses to questions from Dick Vortmann on Manager's II. Mentioned in the document was a City proposal to transfer $25 million. Mr. Sauer wanted to learn more about this proposal, but Mr. Herring did not remember what the proposal was. He assumed it was about transferring money out of excess earnings to the retiree health reserve. Mr. Herring did not remember the analysis. Mr. Sauer asked whether Mr. Herring spoke with Dick about the document. Mr. Herring responded that they only spoke about it in public meetings. Mr. Herring did not specifically remember whether Dick responded, but he noted that they may have discussed it at the next public meeting. Mr. Herring explained that Dick left the meeting before the vote was taken on Manager's II. At that time, Dick appeared to be leaning against it.

D. *Calculations on Impact If Manager's I Trigger Hit*

Mr. Sauer wanted to know whether any calculation was made at the time of Manager's II to determine what the City's liability would be if the trigger were hit. Mr. Herring said that Cathy Lexin gave a presentation based on facts provided by the actuary at the time with such calculations. Mr. Herring did not remember the range of the numbers. Mr. Herring did not know if calculations were performed with respect to the different interpretations of what would happen if the trigger were hit.

VI. <u>Retiree Health Benefits</u>

Mr. Sauer asked whether Mr. Herring had an understanding of the funding of retiree health benefits. Mr. Herring explained that these benefits used to be funded out of a reserve that the

City established, and payments were made directly by the City to pay the premiums. An amendment was placed on the ballot to transfer it to be an obligation of CERS and not the City. It was set up as part of the waterfall. Mr. Herring did not remember exactly how it worked. He noted that it was the subject of much discussion, and the Board received a lot of advice from Mr. Blum. Now the retiree health benefits are paid with excess earnings from CERS, and CERS established a reserve to fund the benefits in years in which there are no excess earnings to pay them. Mr. Sauer asked why it was changed to a CERS liability. Mr. Herring said it allowed for more stability in terms of funding. In addition, the City wanted to lessen the burden on the General Fund. Mr. Sauer asked whether premiums were paid out of the General Fund prior to Manager's I. Mr. Herring was not sure if the change occurred before or with Manager's I. Although he was not sure of the timing, he said it was paid out of the General Fund and Enterprise Funds until the transfer to CERS.

Mr. Sauer then referred Mr. Herring to a document entitled "Modified 7/1/02 Proposal." Mr. Herring did not remember seeing it before.

Next Mr. Sauer referred to a memorandum, dated February 12, 1996, from Mr. Herring to John Kaheny, Assistant City Attorney. The subject of the memorandum was health care funding. Mr. Herring did not remember the memorandum. Mr. Sauer noted that the memorandum mentioned that the practice of using bifurcated rates was not permissible. Mr. Herring explained that this was a method to deal with how to pay premiums. They discovered a legal problem with the method, and Mr. Blum came up with a solution. Mr. Sauer commented that there was a reference in the memorandum to a 1995 Morrison & Foerster opinion on the use of bifurcated rates. Mr. Herring confirmed that this was before Manager's I and commented that it may have been part of the preliminary work leading up to Manager's I.

Mr. Sauer again asked whether the retiree health premiums were paid out of City funds prior to Manager's I. Mr. Herring thought they were. Initially, he did not remember whether the transfer to CERS was directly related to Manager's I or whether it happened before Manager's I. However, Mr. Herring then noted that the payment of retiree health premiums by CERS was addressed in the Manager's I proposal. Mr. Sauer explained that he thought that, before Manager's I, there was a funding strategy where premiums were paid out of CERS. Mr. Sauer believed this strategy was implemented in the early 1990s. Then there was an opinion by tax counsel saying it was done incorrectly. Mr. Herring said he did not remember this but noted that he was not on the Board at that time.

Mr. Sauer asked whether, at the time of Manager's I, were there any projections of the retiree health costs. Mr. Herring did not remember a specific actuary study. Mr. Herring recalled that estimates were given at times while he was on the Board, but he did not remember who gave the estimates. He noted that it was viewed as not being a vested benefit. Mr. Sauer asked if Mr. Herring remembered Larry Grissom giving an estimate. Mr. Herring did not recall. Mr. Herring also did not recall whether Buck Consulting gave an estimate.

VII. Board Elections

Mr. Sauer wanted to know if there were any elections for Board president while Mr. Herring was on the Board. Mr. Herring said there were. He remembered one in particular toward the end of 1999. He said that Keith Enerson and Diann Shipione were the candidates for president in that election. Mr. Herring said he nominated Diann because she asked him to nominate her. Mr. Herring commented that he would not nominate her today. She did not win the election. Mr. Sauer asked if anyone lobbied or recommended that Mr. Herring vote for her. Mr. Herring did not remember anyone doing that. Mr. Sauer asked whether the Mayor or anyone from the Mayor's office contacted him about it. Mr. Herring said he was not contacted by the Mayor or the Mayor's office about it. Mr. Herring noted that Diann's husband may have mentioned it; they played golf together.

VIII. Actuarial Assumptions

Mr. Sauer presented an e-mail dated August 22, 2003, from Mr. Herring to Cathy Lexin and Terri Webster. Mr. Herring explained that the e-mail was related to the *Gleason* settlement negotiations. He said that Manager's II included a requirement that the actuarial assumptions remain frozen to calculate the rate under the agreement. That is, even if the actuarial assumptions were later changed, the actuarial assumptions would remain the same for the purpose of setting the rate under Manager's II. The concern was that there would be a change in the assumptions that would affect the rate. They did not want the rate to change because that would affect the number of years it would take to reach the full actuarial rate. The Board later adopted some actuarial assumption changes, but the changes did not affect the Manager's II rates. The issue was raised during the *Gleason* settlement negotiations that the new actuarial assumptions should be taken into account in determining the City's contribution rate. This was used as a point of negotiation, and the City gave that up in the settlement. The net result was that the rates went up by approximately half a percent.

Mr. Sauer asked whether Mr. Roeder's changes ever reduced the contribution rates. Mr. Herring said that the net effect was always an increase in the rates. Mr. Sauer wanted to know how often the Board declines to accept the actuary's recommended assumptions. Mr. Herring responded that he saw it happen more than once. He noted that sometimes the Board phased-in the assumption changes recommended by the actuary or modified them.

IX. Assessment of Manager's I and II

Mr. Sauer noted that there was a lot of criticism of the funding of CERS. He asked whether in Mr. Herring's view Manager's I was a public policy mistake. Mr. Herring did not think it was a mistake. He felt that the goal at the time was achieved. The goal was to have a labor package that was satisfactory to the union while reducing rates and obtaining relief for the General Fund. Otherwise, cuts in services would have been necessary. Mr. Sauer asked whether the effect was not just to push the cost off to the future. Mr. Herring agreed that this was the effect except that, at the time, the system was very healthy. Had Corbett and other unanticipated events not happened, the chart in Manager's I comparing the agreed rates to the anticipated actuarial rates probably would have been more accurate.

Mr. Sauer asked whether Manager's I was covered in the press. Mr. Herring said it probably was, but he did not remember.

Mr. Sauer then asked whether Manager's II was a beneficial action. Mr. Herring responded that, from the City's perspective, it was because it stabilized the contribution rate.

X. Recommendations

Mr. Sauer commented that there is a lot of concern about how the City will address the perceived shortfall in funding. Mr. Sauer asked Mr. Herring if he had any ideas regarding how the system could be changed. Mr. Herring said that a change in the make-up of the Board makes sense from a public perception standpoint. He said that there might possibly need to be a change in the benefit structure, such as a conversion from a defined benefit plan to a defined contribution plan. Mr. Herring commented that the DROP program is a problem because it is hard to explain. Mr. Herring also said that one solution to the problems would be to issue pension obligation bonds.

Mr. Herring explained that the City will pay the full PUC rate in 2006 under the *Gleason* settlement. After 2009, the Board can do what it wants because the *Gleason* settlement will no longer control, and the City will have to pay what the Board requires. Mr. Sauer questioned whether the City has the financial wherewithal to do that. Mr. Herring said that it does have the financial wherewithal to pay what is required under the Gleason settlement through 2008. Mr. Herring also explained that the 30-year amortization period would be reset. He said that the actuary and fiduciary counsel found this acceptable, and the Board adopted the proposal last week (subject to three small language issues).

Mr. Herring did not think the *Corbett* benefits should be changed if the change would make the benefits vested. Mr. Herring said that all the *Corbett* benefits that are contingent should remain contingent. Mr. Sauer asked whether the drag on surplus earnings from *Corbett* creates a problem with calculating the contribution rate. Mr. Herring responded that there is no drag when the benefits are contingent. Mr. Sauer asked if Mr. Herring remembered Mr. Roeder's complaint about the diversion of assets. Mr. Herring remembered this only vaguely and noted that Mr. Roeder raised it around the time of Manager's II. Mr. Herring felt that this was a legitimate issue, but, knowing the history, he still concludes that these benefits are not vested. Mr. Sauer commented that it's a separate issue of how it impacts the funding of the system. Mr. Herring agreed that it affects the funding. However, he explained that, if you are paying the full actuarial rate (and the City will pay the full actuarial rate in 2006), the impact is taken into account in calculating the UAAL and affects the contribution rates because the asset base loses the earnings. Mr. Herring believes that a lot of the argument goes away when the full actuarial rate is being paid. Also, Mr. Herring emphasized that you need to have a long-term perspective. He will be curious to see what happens in the next two years as the smoothing method moves past the worst years and we see how the market does.

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Mr. Herring also commented that there will not be any benefit increases. All of the media attention, the decline in the funded ratio, the lawsuit, the increased awareness of the issues generally, and the fact that this is an election year and the taxpayers are aware of the underfunding make for a different environment for labor negotiations.

Mr. Sauer asked Mr. Herring if he thought San Diego's problems with the retirement benefits go beyond those of other municipalities. Mr. Herring responded that some are better and some are worse, like Houston and Milwaukee. Mr. Herring said San Diego is very similar to other cities in terms of its benefit increases and the impact of the market downturn. He noted that the underfunding was not so common, but that there are other examples. Mr. Herring said he thought Mr. Roeder mentioned some examples of underfunding by other cities at the time of *Manager's I.*

Mr. Sauer asked whether Mr. Herring had any other recommendations. Mr. Herring commented that the Pension Reform Committee had made recommendations that were impractical and undoable. Mr. Herring said that the City has to find some way to get more funding into the system that is doable, for example real estate transactions or pension obligation bonds.

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